No. 10,206.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

United States of America,

Appellant,

vs.

Don Lee, Inc.,

Appellee.

On Appeal From the District Court of the United States for the Northern District of California, Southern Division

BRIEF FOR DON LEE, INC., APPELLEE.

Zagon, Aaron and Fink,
Samuel S. Zagon,
Max C. Fink,
Nathan Schwartz,
6253 Hollywood Boulevard, Hollywood, California,
Attorneys for Appellee.

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TOPICAL INDEX.

PAGE

Jurisdiction 1

Question presented 2

Statement 2

Summary of argument 2

Argument 3

The taxpayer's basis should be increased by the excess of depreciation reported in prior years over the amount legally allowable, to the extent that such excess does not offset taxable income 3

Conclusion 14

TABLE OF AUTHORITIES CITED.

Cases.

PAGE

Beckridge Corp. v. Commissioner, 129 F. (2d) 318 9

Burnet v. Houston, 283 U. S. 223 12

Burnet v. Sanford & Brooks Co., 282 U. S. 359 11

Burnet v. Thompson Oil & G. Co., 283 U. S. 301 11

Commissioner v. United States & International Securities Corp., decided September 24, 1942 (1942 C. C. H., par. 9667) 7

Hardwick Realty Co. v. Commissioner, 29 F. (2d) 498 (C. C. A. 2d) 9

Helvering v. State-Planters Bank & Trust Co., 130 F. (2d) 44 .... 7, 13

Herder v. Helvering, 106 F. (2d) 153 9

Kennedy Laundry Co. v. Commissioner, 46 B. T. A. 70 .... 6, 13

Lehman v. Commissioner, decided October 1, 1942, Prentice-Hall B. T. A. Memo Service, par. 42,540 9

National Bank of Commerce v. Commissioner, 115 F. (2d) 875 (C. C. A. 9th) 7

Pittsburgh Brewing Co. v. Commissioner, 107 F. (2d) 155 (C. C. A. 3d) 5, 6, 7, 9, 10, 11, 13

Stearns Coal & Lumber Co. v. Glenn, 42 F. Supp. 28 (W. D. Ky.) 7

The Mosler Safe Co. v. Commissioner, decided September 9, 1942, Prentice-Hall B. T. A. Memo. Dec. par. 42,501 6

United States v. Ludley, 274 U. S. 295 9

Virginian Hotel Corp. of Lynchburg v. Commissioner, decided May 6, 1942, Prentice-Hall B. T. A. Service, par. 42,268 6

MISCELLANEOUS. PAGE

40 Columbia Law Review 540 10

STATUTES.

Judicial Code, Sec. 24(20) 20

Judicial Code, Sec. 128 (a) 1

Revenue Act of 1934, c. 277, 48 Stat. 680 3

Revenue Acts of 1934 and 1936, Sec. 113(b)(1)(B) 2

Revenue Act of 1936, c. 690, 49 Stat. 1648, Sec. 23 3

Revenue Act of 1936, c. 690, 49 Stat. 1648, Sec. 113 3

Revenue Act of 1936, c. 690, 49 Stat. 1648, Sec. 114 4

Revenue Act of 1942 (Sec. 116) 8, 9, 13

Revenue Bill of 1942 (H. R. Rep. No. 2333, 77th Cong., 2d Session, p. 116; 1942 Internal Revenue Bull. No. 43 Oct. 26, 1942, pp. 17, 54) 8

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BRIEF FOR DON LEE, INC., APPELLEE.

Jurisdiction.

This is an action to recover income and excess profits taxes alleged to have been erroneously and illegally collected by the United States [R. 2]. The jurisdiction of the District Court is sustained by Section 24 (20) of the Judicial Code, as amended; and that of the Circuit Court by Section 128 (a) of the Judicial Code, as amended. The taxpayer was at all times concerned a corporation organized under the laws of California, with an office in San Francisco. Claims for refund of the taxes alleged to have been illegally and erroneously collected were filed on June 26, 1940, and were rejected by the Commissioner of Internal Revenue on January 25, 1941. The complaint was filed on May 7, 1941. Judgment of the District

Court was entered March 30, 1942, in favor of the taxpayer. Notice of appeal was filed by the United States on May 27, 1942.

Question Presented.

Where the taxpayer reports excessive depreciation of property for the years 1931, 1932 and 1933, but does not benefit from such depreciation by an offset against taxable income for these years because of business losses, should that portion of the depreciation beyond the amount legally allowable be added back to the basis of the property for computing depreciation for the years 1935 and 1936?

Statement.

The case was submitted to the District Court for decision upon the stipulation of facts and the pleadings [R. 10-14, 21]. Appellant's statement of the case sets forth substantially the said stipulated facts, and, therefore, no separate statement is made herein.

Summary of Argument.

The basis of property for depreciation is the cost thereof reduced by the amount of depreciation allowed (but not less than the amount allowable) in previous years. To constitute "allowed" within the meaning of Section 113(b)(1)(B) of the Revenue Acts of 1934 and 1936, the amount of depreciation in excess of that legally allowable must reduce taxable income. Therefore, the excess of depreciation which was reported by the taxpayer in prior years over that legally allowable, to the extent that such excess depreciation did not offset taxable income in those years, should be added back to the basis for computing depreciation of the taxpayer's property in subsequent years.

ARGUMENT.

The Taxpayer's Basis Should Be Increased by the Excess of Depreciation Reported in Prior Years Over the Amount Legally Allowable, to the Extent That Such Excess Does Not Offset Taxable Income.

The taxpayer relies upon the following statutes:

Revenue Act of 1934, c. 277, 48 Stat. 680, and Revenue Act of 1936, c. 690, 49 Stat. 1648:

> "Sec. 23. Deductions from Gross Income.
>
> In computing net income there shall be allowed as deductions:
>
> *   *   *   *   *   *   *   *   *
>
> (l) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *
>
> *   *   *   *   *   *   *   *   *
>
> (n) Basis for Depreciation and Depletion.—The basis upon which depletion, exaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114."
>
> "Sec. 113. Adjusted Basis for Determining Gain or Loss.
>
> (a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; * * *
>
> *   *   *   *   *   *   *   *   *
>
> (b) Adjusted basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) General Rule.—Proper adjustment in respect of the property shall in all cases be made—

* * * * * * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *"

"Sec. 114. Basis for Depreciation and Depletion.

(a) Basis for depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in Section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property."

In the instant case there is no dispute that the taxpayer was the owner of depreciable property or as to the cost thereof [R. 4-5]. The only point at issue is the *basis* upon which the depreciation should be computed. In order to arrive at the basis upon which depreciation should be computed under the above provisions of the Revenue Acts, it is necessary to decrease the cost by the amount of depreciation theretofore allowed but not less than the amount allowable. The Commissioner of Internal Revenue determined that the taxpayer's depreciable properties had a normal and useful life of fifteen years from acquisition and taxpayer agrees with the Commissioner in this regard [R. 13]. Depreciation computed on the fifteen-year life rate would therefore be the amount "allowable", and it would follow that depreciation computed on a ten-year life rate as was used by the taxpayer in the years 1931, 1932 and 1933 was in excess of the amount allowable.

That portion of the depreciation reported by the taxpayer in its income tax returns for 1931, 1932 and 1933 in excess of the amount allowable cannot be regarded as having been "allowed", in view of the fact that the taxpayer sustained during each of those years operating losses which, in fact, exceeded the depreciation reported [R. 13]. This point was considered in the case of *Pittsburgh Brewing Co. v. Commissioner,* 107 F. (2d) 155 (C. C. A. 3d), wherein it was held that depreciation was not "allowed" merely because it was deducted; it was also necessary that it should have reduced taxable income. We quote from the opinion of the Court:

> "Briefly stated, the question for our determination is whether depreciation claimed by the taxpayer in its income tax returns in amounts in excess of those legally allowable, have been 'allowed' within the meaning of the first sentence of Clause (B) of Sec. 113(b)(1), although no taxable income was offset thereby. To put it in another way, is depreciation 'allowed' only if it is actually deducted from taxable income or must it also be considered as 'allowed' if it is reported on an income tax return but not taken as a deduction because of insufficiency of income? After full consideration of this question we have reached the conclusion that depreciation is not 'allowed' within the meaning of the act unless it is actually taken as a deduction against taxable income.
>
> 'Allow' is defined as 'To grant (something) as a deduction or an addition; esp., to abate or deduct; as, to allow a sum for leakage.' Webster's New International Dictionary, 2d Ed., p. 70, def. 5. 'Allowed in the statute accordingly means granted as a deduction. Deduction is defined as 'That which is deducted; the part taken away; abatement; as a deduction from

the yearly rent.' Webster's New International Dictionary, 2d Ed., p. 284, def. 2 b. It is the subtrahend in the process of subtraction. Obviously a minuend is necessary to the process. In the case before us the subtrahend is the depreciation and the minuend is the taxable income. If the minuend income is absent it follows that there can be no deduction and consequently no allowance within the meaning of the act."

Since the taxpayer sustained losses during the years 1931, 1932 and 1933 which exceeded the depreciation, the *excess* of depreciation reported for those years over the amount legally allowable cannot be deemed to have been "allowed" in view of the authority of *Pittsburgh Brewing Co. v. Commissioner, supra.*

That case was followed by the court below, and also by the Board of Tax Appeals in the following cases:

Kennedy Laundry Co. v. Commissioner, 46 B. T. A. 70, appeal to Circuit Court of Appeals for the Seventh Circuit pending;

Virginian Hotel Corp. of Lynchburg v. Commissioner, decided May 6, 1942, Prentice-Hall B. T. A. Service, par. 42,268, appeal to the Circuit Court of Appeals for the Fourth Circuit pending;

The Mosler Safe Co. v. Commissioner, decided September 9, 1942, Prentice-Hall B. T. A. Memo. Dec. par. 42,501.

All of the above are "depreciation" cases, involving the adjustment of the basis of property by adding back the excessive amount of depreciation reported in earlier years when the taxpayer derived no tax advantage because of losses sustained.

We find no case which holds contrary to the rule announced in the *Pittsburgh Brewing Co.* case and followed in all subsequent Board of Tax Appeals decisions involving the same question, nor has appellant cited any in its brief.

Appellant is not in agreement with the view on this matter of the Circuit Court of Appeals for the Third Circuit or of the Board of Tax Appeals in the cases cited above, or of the Court below in the case at bar; but contends that depreciation is allowed within the meaning of the statute when it is claimed by the taxpayer and not opposed by the Commissioner, even though the taxpayer has no net income which is offset thereby. Appellant concludes that the view of the Court in the *Pittsburgh Brewing Co.* case, *supra,* is in conflict with the following cases:

> *Helvering v. State-Planters Bank & Trust Co.,* 130 F. (2d) 44;
>
> *Commissioner v. United States & International Securities Corp.,* decided September 24, 1942 (1942 C. C. H., par. 9667);
>
> *Stearns Coal & Lumber Co. v. Glenn,* 42 F. Supp. 28 (W. D. Ky.), appeal to the Circuit Court of Appeals for the Sixth Circuit pending;
>
> *National Bank of Commerce v. Commissioner,* 115 F. (2d) 875 (C. C. A. 9th).

These cases cited by appellant are all "bad debt" cases, involving the treatment of amounts recovered upon debts charged off in prior loss years. They are ruled by entirely different provisions of the statutes and regulations, concerning gross income, bad debts and recoveries thereof; and are not concerned with the construction of the sec-

tions of the law on depreciation and the basis of property for depreciation.

It should be pointed out further with respect to the "bad debt" cases, that the House of Representatives Ways and Means Committee in its report on the Revenue Bill of 1942 (H. R. Rep. No. 2333, 77th Cong., 2d Session, p. 116; 1942 Internal Revenue Bull. No. 43, Oct. 26, 1942, pp. 17, 54) comments as follows:

> "There is at present considerable confusion as to the state of the law regarding the recovery of bad debts or taxes which have been taken as deductions in previous years. The confusion has arisen as to whether the taxation of the amount of the bad debt or tax recovered in the year of such recovery depends upon the tax benefit which the taxpayer derived from the deduction of those items in a prior year.
>
> The bill settled this question by excluding from the gross income of the taxpayer in the year of the recovery the amounts recovered to the extent that the debt or tax did not in any prior taxable year reduce his income tax liability. * * *"

The Revenue Act of 1942 (Sec. 116) clarifies the law relative to bad debt recoveries by an express provision, made retroactive to all taxable years, excluding such recoveries from income where the debt was charged off in a prior loss year to the extent that tax liability was not reduced thereby.

We submit, therefore, as to the aforementioned cases cited by appellant, first, that they are not in point because they involve the construction of entirely different sections of the statute, and second, that the rule involved in those cases cannot be regarded as the correct interpretation of

the law or as an expression of the intent of Congress in view of the aforesaid Committee Report, *supra,* and Sec. 116 of the Revenue Act of 1942. Moreover, in none of the said cases did the Court draw any analogy between the bad debt provisions of the law and the depreciation sections of the law.

Appellant points out that, although there was no specific provision prior to the 1924 Act with respect to adjustment for depreciation in computing gain or loss from a sale of property, the courts have held the basis should be reduced by the amount which was legally allowable in past years even though no such deduction was taken and no tax advantage would have resulted if it had been taken. With this point and the authorities cited to support it (*United States v. Ludley,* 274 U. S. 295; *Hardwick Realty Co. v. Commissioner,* 29 F. (2d) 498 (C. C. A. 2d), we are in full accord. So also are we in agreement with the authorities cited by appellant (namely, *Beckridge Corp. v. Commissioner,* 129 F. (2d) 318; *Herder v. Helvering,* 106 F. (2d) 153) to the effect that the statute provides for adjustment in respect of the allowable depreciation, where that is greater than the amount allowed, even though no deduction was ever claimed.

The rule of the *Pittsburgh Brewing Co.* case, *supra,* does not apply where the prior deduction was allowable. (*Lehman v. Commissioner,* decided October 1, 1942. Prentice-Hall B. T. A. Memo Service, par. 42,540. The taxpayer should report in each taxable year the amount of depreciation to which he is entitled (*U. S. v. Ludley, supra*), i. e., the amount "allowable." If he reports less than the amount allowable or none at all, the basis for future depreciation must nevertheless be reduced by the

full amount of depreciation allowable in previous years. The statute defines the minimum adjustment for depreciation as the amount allowable. If, however, the taxpayer reports depreciation in excess of the amount legally allowable, then the rule of the *Pittsburgh Brewing Co.* case applies and the excess depreciation is deemed allowed to the extent that it reduces taxable income. The court in the *Pittsburgh Brewing Co.* case fully considered the intent of Congress and, after examining into the legislative history of the pertinent provisions and the House Ways and Means Committee report there, concludes:

> "Obviously the Committee referred to the situation in which a taxpayer, having had the benefit of a larger depreciation deduction from gross income than was properly allowable to him, claims upon the sale of the depreciated property that his sale basis should be increased by deducting only the smaller depreciation properly allowable, thus gaining a double deduction against taxable income. We think it clear that it was to prevent the probability of such a double deduction that the provisions of the Revenue Act of 1932 [identical with the corresponding provisions of the Revenue Acts of 1934 and 1936] which we are considering were enacted. No double benefit can be received where, as in the case before us, the depreciation originally claimed offsets no taxable income which would otherwise have been taxable."

Appellant invites attention to a Columbia Law Review article (40 Columbia Law Review 540) where it is concluded that the *Pittsburgh Brewing Co.* case was erroneously decided. In that article the author was under the erroneous impression that the court had decided, contrary to law, that the basis should not, under any circum-

stances, be reduced by depreciation unless the taxpayer actually received the benefit thereof as a deduction from taxable income, whereas in fact, as was pointed out above, the doctrine of the *Pittsburgh Brewing Co.* case applies only to the amount of depreciation *in excess* of that legally allowable.

Appellant has cited three other cases not heretofore discussed in this brief. Two of them deal with the rule that each taxable year must be regarded as an independent unit for income tax purposes. (*Burnet v. Sanford & Brooks Co.,* 282 U. S. 359; *Burnet v. Thompson Oil & G. Co.,* 283 U. S. 301, 306.) Again, we do not dispute the rule, but contend that it has no application to the issue involved in the case at bar. Appellant states that it would be contrary to that rule to permit a taxpayer to reduce his income for one year merely because he derived no tax advantage from a deduction taken in a previous year. That is not our contention. Rather, we are here concerned with the rule for correctly determining the basis as of a given date on which to compute depreciation subsequent thereto, and in this regard the statutes and regulations cited in both the appellant's and our briefs prescribe the method for arriving at the correct basis, which is to decrease the original cost by the amount of depreciation theretofore "allowed", but not less than the amount "allowable". If a taxpayer failed to deduct the full amount of depreciation allowable in any year, such taxpayer would nevertheless be required to use as a basis for depreciation in subsequent years the cost reduced by the full amount of allowable depreciation. On the other hand, if the taxpayer deducted depreciation in excess of the amount allowable, and benefited from such excessive depreciation through reduction of taxable income, then the

basis for depreciation in subsequent years would be the cost less depreciation actually deducted even though in excess of the amount allowable. The third situation, which is that obtaining in the instant case, is where a taxpayer reports depreciation for prior years in excess of the amount legally allowable and does not benefit because there was no taxable income offset thereby. The basis for depreciation in subsequent years would be the cost reduced by the amount of depreciation allowable rather than the amount actually reported.

The remaining case mentioned by appellant but not heretofore discussed in this brief is *Burnet v. Houston,* 283 U. S. 223, cited in connection with appellant's contention that the taxpayer has failed to sustain the burden of proving the absence of tax advantage because the record does not contain the tax returns. It will be recalled that this case was submitted to the District Court for decision upon the stipulation of facts and the pleadings. The taxpayer in its complaint alleged that in the years 1931, 1932 and 1933, and each of them, it sustained operating losses; losses for each said year being in excess of the depreciation reported in each such year [R. 3], and appellant in its answer admitted that the taxpayer *in its returns* for 1931, 1932 and 1933 claimed and reported operating losses which were in excess of the amount of depreciation reported for each of said years [R. 8]. Furthermore, the parties stipulated that the taxpayer sustained operating losses during the years 1931, 1932 and 1933 which, in fact, exceeded the depreciation

reported [R. 13]. The agreed statement of facts, therefore, obviated the necessity for establishing the individual expense items and other deductions authorized by law which in the aggregate, exclusive of the deduction for depreciation, exceeded the taxpayer's gross income reported in its income tax returns for each of the years 1931, 1932 and 1933. Since the stipulation that there were losses could mean only that the expenses exceeded the gross income, we submit that it is now an undisputed fact that the taxpayer did not receive a tax advantage by reason of the excessive depreciation reported.

Finally, appellant maintains that it is erroneous to assume that a taxpayer derives no tax advantage from any particular deduction merely because he has no net income for the year in question; and, further, that there would be administrative difficulties in applying the rule approved by the court below. In support of the former contention, appellant cites the dissenting opinion in *Kennedy Laundry Co. v. Commissioner, supra.* The Board of Tax Appeals in that case followed the rule announced in the *Pittsburgh Brewing Co.* case. We submit that the reasoning of the dissenting opinion as well as the comment of the court in *Helvering v. State-Planters Bank & Trust Co., supra,* in support of appellant's latter contention, cannot be given current weight in view of the expression of legislative intent announced in connection with the enactment of Section 116 of the Revenue Act of 1942, to exclude bad debt recoveries from income where the debt was charged off in a prior tax year to the extent that tax

liability was not reduced thereby. Congress has thus nullified and overcome the objections raised by appellant relative to the tax benefit theory by expressly approving it as to recovery of bad debts, prior taxes, and delinquency amounts. It has been shown above that this action was taken by Congress to eliminate the confusion existing in the state of the law regarding the recovery of bad debts or taxes which had been taken as deductions in previous loss years.

In view of the foregoing, it is submitted that the basis of the taxpayer's property should be adjusted by adding back the excess of depreciation reported in prior loss years over the amount legally allowable, since the excess did not offset any taxable income.

Conclusion.

The judgment of the court below should be affirmed.

Dated: December 16, 1942.

Respectfully submitted,

Zagon, Aaron and Fink,
Samuel S. Zagon,
Max C. Fink,
Nathan Schwartz,
Attorneys for Appellee.